

## From the Editor....



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### Market Update

It appears that after a period of relative investment calm, equity market volatility is back with a vengeance. The 250-point fall in the Dow at the end of October marked the 10th triple digit move during the month for US equities. In addition, after falling 11% following the better-than-expected September GDP growth figure, the Volatility Index (VIX), or “fear” index as it is commonly known as, abruptly reversed course on the 30th October rising an incredible 25% to its highest level in nearly 4 months. This sharp reversal for the Dow Jones Index could prove to be a significant short term inflection point for global equity markets.

The catalyst for the US volatility was the release of weaker September consumer sentiment, and personal income and spending figures, which point to a potential slowdown in consumer spending. Considering consumer spending has historically represented 70% of GDP growth, this has very negative implications for the economy. Consequently, we think the big falls in US equity markets last week, and the sharp increase in the VIX, represent an investor realization of the inherent risks for US economic growth due to the diminishing effects of the massive \$US787 billion fiscal stimulus package. The government expects the effects of the fiscal stimulus will have ended by June 2010. Therefore the official forecast is for US GDP growth of just 2.5% next year. However, private forecasts are significantly lower. As a result, there is a real possibility that “fiscal fade” will result in the September

quarter being the high point for US economic growth until 2011 at the least.

An analysis of the 3.5% GDP growth for the September quarter revealed that government spending contributed 50% to 75% US economic growth. In this regard, driven by the government’s massive “cash for clunkers” program, auto sales contributed 1% point to September quarter GDP growth. In addition, supported by the government’s US\$8,000 tax exemption for first home owners, housing contributed 0.75% of a point to third quarter economic growth. Importantly, the “cash for clunkers” program is complete and the housing tax exemption is due to end in November. It is therefore important to understand that the rebound in economic growth has been primarily driven by government spending initiatives. The US third-quarter GDP result was clear proof of this.

The Australian economy has also been significantly supported by the government’s fiscal stimulus with the Treasury recently confirming it contributed 1.9% to the 2007/08 GDP growth of 0.6%. Subsequently the Treasurer also added, “To entirely remove fiscal support from the economy at once would reduce growth by 2.5% in 2010.” In addition, Australia’s leverage to China, which recently reported third quarter GDP growth of 8.9%, is often highlighted as a positive for the domestic economy. However, the 4 trillion Yuan stimulus, or 15% of GDP, was largely directed to infrastructure investment which has contributed as much as 55% to China’s economic growth this year. As a result, we continue to believe

that the massive government stimulus packages have supported unsustainable price to earnings expansion for global equities.

You could also argue that US economic growth is being further supported by unsustainable government actions. Currently US interest rates are zero which has driven a 15% decline in the US dollar index over the last 6 months. The result was US export growth of 12.5% in the September quarter and stronger-than-expected currency driven third quarter earnings growth for the US multinationals. However both are clearly unsustainable trends over the medium term. More importantly however, the Fed is committed to buying \$US1.5 trillion in mortgage backed securities by March 2010 and has just completed a \$US300 billion quantitative easing program buying US treasuries.

Consequently a highly expansionary monetary policy and quantitative easing program has resulted in a massive US government-driven liquidity pool which is already fueling a new equity market, and hard commodity, bubble in non-US dollar assets. It is worth noting that the domestic equity market and the Australian dollar have both rallied equally by just over 50% from the March lows. This is not a coincidence. We continue to believe that equities are not reflective of genuine economic fundamentals, but are currently being driven by currency trading momentum.

Clearly the strength of the US economy is largely being supported by government support, fiscal spending initiatives, or irresponsible policy. Since June last year the US government has implemented nearly \$US3 trillion in official spending programs. The government has bailed out Bear Sterns with US\$30 billion, Fannie Mae and Freddie Mac with US\$400 billion, AIG with \$US180 billion, Citigroup with US\$280 billion, Bank of America with \$US142 billion, all of which still remain hostage to cheap government funding. This is in addition to the government spending \$US700 billion through TARP buying mortgage backed securities. But this is independent of the bailout of the car industry, the "cash for clunkers" program, and the housing tax exemption for

first home buyers. In addition, the Fed has artificially driven interest rates to zero, supported a \$US1.5 trillion purchase of mortgage backed securities and initiated a \$US300 billion quantitative easing program. Is there any area of the US economy not dependant on government support? As a result, we believe earnings are anything but transparent. Yet in the short term investors appear happy to apply a P/E premium to unsustainable government spending policies.

In the meantime, 7.5 million US jobs have been lost since the recession began in December 2007. This has resulted in a 30-year high of 10.2% for the unemployment rate which is not expected to peak until late 2010 at 10.5%. More importantly, economic growth of at least 3% is required to support new job creation. However current official forecasts are just 2.5%. In addition, the results of the major investment banks, which have been supported by cheap government funding, are not indicative of the real state of the nation's banking industry. Currently 106 banks have failed while many more are likely. The Federal Deposit Insurance Corp has another 416 on its problem list. Moody's recently reported that US banks are writing off the same proportion of loans as the Great Depression and expects cumulative write-offs to reach \$US415 billion for both 2009 and 2010. This compares with \$US135 billion this year.

The recent results for the US investment banks revealed the bulk of earnings gains were trading profits driven by cheap government funding rather than lending to consumers and corporates. A large part of the banking system remains paralysed. The mortgage securitization market provided up to 60% of lending from a peak of \$US750 billion in 2005, to just \$US8 billion in the first half of this year. A healthy economy is characterized by strong employment growth and a functioning well-capitalised banking industry. The US has neither. We therefore expect the US economy is set to experience weak and below trend economic activity and corporate earnings growth over the next few years.

Consequently we believe the fiscal stimulus driven P/E expansion of US equities based on the expectation of a strong “V” shaped recovery is unsustainable, and the outlook for US earnings growth remains uncertain. There are few genuine signs of organic sustainable global economic growth which is not dependant on government spending or support.

In contrast to the current consensus view of a strong expected recovery in earnings, we believe the latter stages of the recent rally have been fuelled by US dollar “carry trades” and a massive global liquidity pool created by highly expansionary US monetary policy. Considering the strength of the recent rally, and the current level of some cyclical valuations, these are very uncertain times for equities. It does appear that investors have learnt nothing from last year’s meltdown.

The bulls will argue that Australia is better positioned with its leverage to the strong Chinese economy. While that is true it is worth noting that both Australia and China have also been supported by large government fiscal stimulus packages which are expected to fade by the middle of next year. There is simply no global economy which has not been supported by significant government spending. However, the bulls will also acknowledge that recent events clearly show the performance of global equities remain inextricably linked to the US equity market. In this regard there is speculation mounting that the next phase of the US financial crisis will be a meltdown in the commercial real estate market. This follows on from the announcement that Capmark Financial, one of the largest lenders to the US commercial property market, has filed for bankruptcy. A commercial property meltdown would be the last straw for US banks which remain dependant on US government support. In addition, such an event would undoubtedly precipitate a genuine US equity correction. Make no mistake, despite Australia’s relative economic strength; there is little doubt that Australian equities would mimic the US fall.

In the meantime the recovery in global equity markets from the March lows has been the fastest in history. In addition, the world economy remains in an uncertain transition period

between government support and genuine economic recovery. As a result, one thing is certain. Volatility is set to increase significantly after a period of relative equity calm.

### US Job Numbers

Recent unemployment data out of the US showed that 10.2% of Americans are without a job. Data suggests the headline unemployment rate will peak around 11% while “underemployment” is somewhere in the mid 20%’s. Eventually Wall Street will need job creation to justify the V-shaped recovery the cheap money carry trade has priced into markets at present.

80% of the S&P 500 third quarter earnings came in better than expected. Almost all of those corporate earnings surprises were driven by costs being lower than expected. The easiest way to cut costs and maintain profitability for shareholders is to fire workers and that is what the US corporate sector continues to do. But firing workers is not a long-term solution to the US economy’s issues. Eventually to grow revenues these companies are going to have to re-hire labour and we just cannot see how you can cost cut and save our way out of recession. In other recent data released, American households cut borrowing for the 8th straight month in September. That is the longest continuous contraction in US household borrowing since 1943. While US households need to repay their high levels of gearing, this data shows us, when combined with 10.2% unemployment, that the US consumer will be in hibernation for some time.

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Information in this Newsletter is drawn from various sources, including extensive and comprehensive research by FN Arena, Bloomberg and the local press.  
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